THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

June 15, 1965

MEMORANDUM FOR THE PRESIDENT

Subject: The Stock Market in Perspective

It is always impossible to account for the stock market's short-run gyrations. It is more impossible than usual to understand what has been going on in the past few weeks. But the following facts and figures may help to put the recent decline in perspective.

1. The drop in the market of recent weeks is not huge in percentage terms.

- After the closing rally today, the Dow-Jones industrial index stands at 875, down 7% from its May 14 high of 940.
- In contrast
  - -- the decline from December 1961 to August 1962 was 200 points, or 27%;
  - -- just from May 18 to 28, 1962, the market plummeted 11%;
  - -- the 1960 drop was 17%; and
  - -- the 1957 plunge was 19%.
- Stock prices are still above any level attained before October 1964.
- Nevertheless, the decline is larger than any since 1962. And, most important, we do not know whether the market has hit bottom.

2. Stocks have not been selling at bargain prices. But neither have they been unusually high in relation to earnings.

- Industrial stocks are now selling at 17 to 18 times annual earnings.
- The price-earnings ratio has been in the 17-18 range for most years since 1958, with stock prices rising in parallel with profits.
- Prior to 1958, however, the price-earnings ratio was not above 15 during the postwar period.

3. There are some shock absorbers within the stock market to help limit declines, including

   -- the need for pension funds and large institutions to keep investing their inflow of new funds, and

   -- the fact that margin calls are not a serious threat since so little common stock is now held on credit.

   Needless to say, theses do not set any firm floor on the market.

4. The market has been extremely nervous.

   - The rumors about your health last week, and a variety of persistent scare stories about Vietnam, indicate that some people are looking hard for things to worry about.

   - Bill Martin's speech certainly hurt, but nothing he said should have made any sophisticated investor run for cover.

   - Not many stock market experts are really bearish. But many professionals will wait to buy until a rally has firmly begun. (It is difficult for a rally to start if very many take this position.)

5. The big issue is what the drop in the market will mean for the economy.

   - The market may be a barometer of business sentiment; but there is strong independent evidence that businessmen are confident about the future course of the economy.

   - The market has a direct -- but limited -- influence on the economy on the economy by affecting corporate decisions about raising new equity capital.

   - The big imponderable is whether the market will have an indirect influence in reducing business confidence about the economic outlook.

6. This indirect influence may exist. But the stock market has not in the past had much effect on production, income, and jobs.

   - Even the 200 point nosedive in 1962 did not cause consumers to tighten their belts nor businessmen to retrench in any significant degree. And a 23% drop in the stock market in 1946 was actually followed by an inflationary boom.

- Drops in the market which have preceded recessions have been accompanied (and usually anticipated) by slowdowns in business activity. But now the market is the only economic indicator that looks bad.

7. The financial press naturally stresses stock prices because it is aimed at readers who are active in the market. At the same time, the majority of Americans own no common stock at all; and thinking on Main Street does not fluctuate with prices on Wall Street.

8. It is easy for Government officials to concoct statements that depress stock prices. But no one has ever found the right formula for a comment on Wall Street that would make the market go up. That's why I'm going to keep stressing publicly the favorable factors in our economic outlook. But I'm not going to make any direct comment on the market.

Gardner Ackley